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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	)	MM Docket No. 93-215
	)	
and	)	
	)	
Adoption of a Uniform Accounting System for Provision of Regulated Cable Service	)	CS Docket No. 94-28

COMMENTS OF COMCAST CABLE COMMUNICATIONS, INC.

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July 1, 1994

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SUMMARY

The current cost of service rules create significant disincentives to investment in cable television. The Commission should correct those disincentives by increasing the permitted rate of return in cost of service showings, by declining to adopt a "productivity offset," and by adopting new rules that permit cable operators to recover and earn a return on assets acquired before regulation.

It is vital for the Commission to adopt a higher return on capital for cost of service showings. The current interim return greatly disadvantages cable operators in the financial markets, especially as compared to telephone companies. Because cable is subject to significant competition from many sources, while local telephony is not, the adoption of identical returns for both industries assures that the cable industry will be unable to attract the investment it needs. This result is contrary to the requirements of *Hope* and other rate regulation cases.

The Commission should not adopt a productivity offset for going-forward cable rates. There is no evidence that cable productivity exceeds the national norm. Rather, cable costs are likely to increase in the future as operators strive to comply with the new obligations imposed by the 1992 Cable Act and as they begin to serve less densely populated, more expensive areas of their markets.

Finally, the Commission should modify its current rules to permit recovery of and a return on assets acquired prior to regulation. It can best do so by adopting the proposals in Comcast's recent petition for reconsideration of the cost of service order.

TABLE OF CONTENTS

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COMMENTS OF COMCAST CABLE COMMUNICATIONS, INC.

Comcast Cable Communications, Inc. ("Comcast"), by its attorneys, hereby submits its comments in response to the *Further Notice* in the above-referenced proceeding.[1/] These comments focus on two issues raised in the *Further Notice*. First, the Commission should increase the return permitted to cable operators to account for the financial markets' recognition of the riskiness of the cable business. Second, the Commission should not adopt a productivity offset for cable operators regulated under the price cap. In addition, the permanent cost of service rules should be consistent with the rules proposed by Comcast in its petition for reconsideration of the interim cost of service rules.

1/ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, *Report and Order and Further Notice of Proposed Rulemaking*, FCC 94-39, rel. Mar. 30, 1994 (the *"Further Notice"*).

I. Introduction

Comcast currently is the fourth-largest cable operator in the country. Comcast has grown by constructing new cable systems and by acquiring and upgrading systems when doing so would enhance operational efficiencies or otherwise benefit subscribers and Comcast's shareholders. Most recently, Comcast has agreed in principle to purchase the cable systems now owned by McLean Hunter.

Comcast's success has been a result of its commitment to high quality service and to long-term investment in providing cable service. Comcast's focus on long-term investment and quality service has been possible only because it has been able to attract new capital from public debt and equity markets. Comcast fears, however, that some of the interim rules and proposals in this proceeding are likely to make it difficult, if not impossible, to attract capital in the future.

First, the interim return on capital adopted by the Commission is insufficient to permit cable operators to compete for capital with other businesses. The Commission should modify the permitted return on capital to reflect the greater risks faced by cable operators than by providers of telephone service.

Second, the Commission should decline to adopt a productivity offset to cable price caps. The new rate regulation rules have resulted in significant decreases in cable rates already, and there is no evidence that cable operators can achieve productivity increases going forward. At the same time, cable operators' obligations and corresponding costs have been increased significantly by the requirements of the 1992 Cable Act. Adoption of a productivity adjustment also would make it harder for cable operators to obtain capital. The likelihood of adequate returns on investment would be greatly reduced by a productivity offset.

Finally, the Commission should adopt permanent cost of service rules that are consistent with the rules proposed in Comcast's petition for reconsideration in this matter.[2/] The key elements of those proposals include:

(1) Permitting recovery of and a return on net investment in tangible and intangible assets acquired in arms length transactions prior to the enactment of the 1992 Cable Act;

(2) Transition rules for companies that incurred significant costs prior to regulation that could be disallowed under the current rules; and

(3) Permitting cable operators to follow generally accepted accounting principles when keeping their books, rather than adopting the proposed uniform system of accounts for cable operators.

II. The Commission Should Modify the Allowed Rate of Return to Account for the Risks of the Cable Business.

The *Further Notice* requests comment on the interim 11.25 percent rate of return adopted by the Commission. *Further Notice* at ¶ 305. While the *Further Notice* solicits responses on several specific issues, the most fundamental issue is that the current rate of return is simply too low, especially when compared to the rate of return set by the Commission for the telephone industry.[3/] Because the

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2/ A copy of Comcast's petition for reconsideration is attached as Exhibit 1 and is hereby incorporated by reference in these comments.

3/ The Commission must recognize that its 11.25 percent return on capital

(continued...)

Commission's uniform rate of return for the cable industry will have a profound effect on investors' decisions whether to fund the capital needs of the industry, it is extremely important to set it properly.

The comparison between the rate of return for cable and other industries is particularly significant because investors are unlikely to invest in the relatively risky cable industry if they know that they can get the same or better returns from the less risky local telephone industry. Thus, reaching a reasonable rate of return for cable and maintaining an appropriate differential between authorized returns for cable and telephony is crucial. If the Commission fails to maintain this differential, it will prevent the cable industry from obtaining the capital it needs.

A. Cable Is Inherently Riskier than the Telephone Business.

There can be little question that cable is an inherently riskier business than local telephony. While the telephone companies have argued that "convergence" is merging the two industries, the reality is that cable faces much more competition than telephony and there are significant prospects of even more competition, from telephone companies and others. At the same time, cable, unlike telephony, is not an essential service, a fact demonstrated by the substantially lower penetration rates for cable (less than 65 percent) than for local telephone service (close to 95 percent).

3/ (...continued)
approximates the cost of debt for many, if not most, operators. Because a cable operator's equity holders are entitled to a return commensurate with the risks of the investment, the Commission must adopt a higher overall return if those equity holders are to be fairly compensated.

Cable is subject to competition on many levels, and there are many substitutes for cable service. The most obvious competition is broadcast television, which is the source of more than 76 percent of all television viewing.[4] Cable also is subject to growing competition from other multichannel video providers, such as satellite services, MMDS and, beginning this year, Direct Broadcast Satellite.

The extent of the competition from these services should not be underestimated. Television receive-only dishes are now in approximately 1.7 million homes, a more than 120 percent increase from the 770,000 homes with TVRO dishes at the end of 1991.[5] As Chairman Hundt noted in his recent speech to the Wireless Cable Association, there are now nearly 200 wireless cable systems in operation throughout the U.S., and the growth rate for wireless cable is phenomenal: One wireless cable provider in Tucson has grown from 13,000 to 22,000 subscribers in less than a year and the wireless cable provider in Philadelphia is increasing subscribership at a rate of six percent a month, equivalent to an annualized growth rate of 101 percent.[6]

Similarly, VCRs, which have an average penetration level considerably higher than cable, also are an important alternative to cable because they permit

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4/ *See* Nielson Media Research, *1992-1993 Report on Television* (1993) at 14 (comparing viewership for cable and broadcast programming).

5/ *See The Kagan Media Index*, June 20, 1994 at 8, 14.

6/ This competition also should not be assumed to be limited to specific areas. For instance, although satellite services often are thought of as concentrated in more rural areas, many homes in the northern part of Philadelphia have satellite dishes.

consumers to time shift shows they would not otherwise watch and to rent movies or other programming comparable to what is found on cable. VCR penetration has exceeded cable penetration since 1987 and continues to grow at a faster rate than cable penetration.[7] Indeed, cable operators often obtain rights to popular movies only after they have been released to the video rental market, and some popular movies are never available through cable outlets.

The risks of cable have been further increased by the provisions of the 1992 Cable Act that have both eliminated programming exclusivity for cable operators and mandated that cable programming be available to competitors on comparable terms. *See* 47 U.S.C. § 548. As a result of these new requirements, cable operators have lost one of their most significant advantages over their competitors, the ability to offer unique programming. This unique programming, including such networks as HBO and MTV, was the engine of the tremendous growth of cable in the 1980s. Now the same programming is being made available to cable's competitors at comparable rates, terms and conditions after cable operators have made the investment necessary to create consumer demand for those services. Because cable's competitors do not have to make these same investments, the risk of their services has

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7/ VCR penetration now exceeds cable penetration by more than 14.5 million households. In percentage terms, VCR penetration has grown faster than cable penetration in every year since 1979, the year the Television Bureau of Advertising began keeping figures for VCR penetration. In terms of the number of new households gained, VCR penetration has grown faster than cable penetration in every year since 1985. *See* Television Bureau of Advertising, *Trends in Television* (October, 1993).

been reduced and the future risk of being a cable operator has been increased. Moreover, exclusive programming arrangements are now generally unavailable to cable operators as a marketing tool. Cable's competitors are not similarly constrained.

Competition to local telephone companies is considerably more limited. The emergence of competitive access providers ("CAPs") may suggest that competition is possible, but no CAP has as much as one percent of the total local telephone market in even a single metropolitan area. By comparison, the total market share for cable's competitors is much greater. Meanwhile, cellular provides no competition because it is much more expensive than landline telephony.[8] Commercial PCS service is not expected to emerge until late 1995 or 1996, and is unlikely to provide a meaningful competitive threat to telephone companies until years after its introduction.

The higher level of competition faced by cable guarantees that it will be riskier than telephony. At the same time, cable also faces a much more volatile marketplace than telephone companies. Cable is a discretionary service, and consumers choose not to subscribe or to drop their cable service on a regular basis. Cable penetration rates can and do vary meaningfully with changes in economic conditions. Telephone service, on the other hand, is considered essential, as reflected

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8/ Cable's competitors, on the other hand, tend to be less expensive than cable service. In particular, over the air television is free. Other competitors have lower costs because they do not need to install extensive wired infrastructure, allowing them to underprice cable service.

in the Commission's commitment to universal telephone service, and as reflected in the steady growth in telephone penetration.

The differences in risk also are illustrated by the actual penetration of cable and telephone service. As the Commission reported on May 12 of this year, telephone penetration long has been over 90 percent and has now reached 94.2 percent nationwide.[9] Cable penetration lags about 30 percent behind, at between 60 and 65 percent, depending on the estimates used in the calculation, even for television households that have access to cable service.[10] In fact, the national **average** for telephone penetration is higher than cable penetration in any one state and the national average for cable penetration is about 20 percent lower than the telephone penetration in the state with the worst telephone penetration. It is obvious from this comparison that consumers do not consider cable an essential service, and this greatly increases the risk of the cable business. Cable has enjoyed robust growth in the past — especially during the period of deregulation from 1984 to 1992 — and has become an important service for consumers, but it remains non-essential nevertheless.

9/ *Trends in Telephone Service,* rel. May 12, 1994 at 3.

10/ *See Cable Television Developments,* National Cable Television Association, Apr., 1994, at 1-A, 12-A. The NCTA estimates slightly overstate cable penetration, because they only consider television households. The estimates of telephone penetration are based on all households in the U.S.

B. Financial Markets Recognize the Risks of the Cable Business.

One of the functions of financial markets is to evaluate and recognize the business risks of the companies that come to those markets to obtain capital. This basic function is accomplished through mechanisms such as bond ratings and the interest rates paid on debt, preferred stock and other obligations offered by a company in the financial markets. By the standards of the financial markets, the cable business is riskier than the telephone business.

It is irrefutable that financial markets rate cable companies as riskier than telephone companies. Telephone bonds are uniformly given investment grade ratings, almost always above the minimum investment grade rating.[11] Cable bonds, on the other hand, are almost never given investment grade ratings, and the few investment grade ratings for cable companies were obtained only just before the 1992 Cable Act was adopted. No cable company has debt ratings as high as the average local telephone company.

The higher risk of cable also is reflected in the marketplace. Cable and telephone debt instruments with comparable maturities trade at significantly different

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11/ For instance, Standard & Poors, when it revised its criteria for rating telephone debt in 1988, eliminated the criteria for "BB" ratings, the first rating below investment grade, because no telephone company was rated lower than "A," the second investment grade rating.

interest rates.[12/] Unsurprisingly, the differences in market interest rates are consistent with the differences in debt ratings for cable and telephone companies.

The significance of the differences in ratings and interest rates is that they reflect the investment community's perception of the returns necessary to offset the risks associated with investments in cable and telephone companies. Cable returns are higher because investors know that the cable industry is riskier than the telephone industry. If there were no differential between the returns available from cable and telephony, no rational investor would choose to invest in cable rather than telephony because the risks of investing in cable are significantly higher. If the returns were equal, investing in cable rather than telephony would be like making a bet on a two to one proposition for an even money payoff. No rational investor would make such a bet, and few investors not otherwise constrained would choose to put their capital into the cable business under those circumstances.

12/ For instance, comparison of publicly-traded debt issued by Time Warner with that of the NYNEX telephone companies shows that the yield of Time Warner debt typically was more than 100 basis points higher than that of the NYNEX companies, as of June 29, 1994. The difference was as high as 157 basis points, depending on the maturity of the debt. This difference is all the more dramatic because NYNEX is perceived as one of the riskier telephone companies and Time Warner is one of the less risky cable companies by virtue of its diversification and size. A yield curve, showing the yields of the two firms' debt across all maturities, graphically demonstrates the consistent differences in the interest rates debt holders expect. A yield curve and the underlying data, based on rates on June 29, 1994, are attached as Exhibit 2.

C. Ratemaking Jurisprudence Requires the Commission to Account for the Differences in the Risks Faced by the Industries It Regulates.

Much has been said in this proceeding about the adequacy of the Commission's rate regulations under the constitutional standards set in *Hope* and its progeny.[13] One of the key issues in these cases is the ability of the regulated entity to earn a sufficient return on its capital to attract investment. *See, e.g., Hope,* 320 U.S. at 605. In this context, it is not enough for the Commission to calculate a return that is sufficient in the abstract; rather, for a return to be constitutionally sufficient it must be high enough to attract investment in light of actual market conditions.

Comcast does not believe that an 11.25 percent return would be sufficient under any circumstances, but in the context of the rate of return afforded to telephone companies by this Commission a higher return is necessary for the cable industry to obtain the capital it needs. As shown above, there is little question that the cable industry faces more risk than the telephone industry, so a rational investor will require a higher return from a cable company than a telephone company.

At the same time, the 11.25 percent return chosen by the Commission is, in practice, lower than the return permitted to telephone companies. As Comcast described in its petition for reconsideration, telephone companies are permitted to

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13/ *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591 (1944) ("*Hope*"); *see also Washington Gas Light Co. v. Baker,* 188 F.2d 11, 15 (D.C. Cir. 1950), *cert. denied,* 340 U.S. 952 (1951).

earn up to 11.50 percent without being subject to overearning complaints and price cap LECs may earn up to 12.25 percent before sharing begins and the sharing mechanism permits LECs to earn and keep up to a total of a 14.25 percent return. *See* Exhibit 1 at 19.

Under these circumstances, the balance of risks and returns so favors telephone companies that the rate of return is constitutionally infirm. The *Hope* analysis requires the Commission to set returns such that sufficient investment will be attracted to the regulated entity. Giving equal returns to two industries with patently different levels of risk cannot meet the *Hope* standards because doing so guarantees that the riskier industry will not obtain sufficient investment. Where, as here, the less risky industry (telephony) actually has the opportunity for higher returns than the riskier industry (cable), the deficiency under *Hope* is even more obvious.[14/] In fact, the 11.25 percent return allowed cable operators can be said to be "adequate" only if it is assumed that the telephone rate of return is excessively high. The Commission can correct this deficiency by increasing the cable rate of return to a level that

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14/ In addition, the Commission's presumptive disallowance of investments in assets acquired prior to the onset of regulation also effectively eliminates any incentive to invest in the cable industry. *See* Exhibit 1 at 15-17. The Commission must both correct the rate of return and adopt ratebase presumptions that allow inclusion of pre-regulation assets to satisfy *Hope*. As discussed in Part I, *supra*, Comcast submits that the Commission should adopt its proposals for inclusion of pre-regulation assets in the ratebase, which were described in Comcast's petition for reconsideration of the Report and Order portion of the *Notice*, and incorporates that petition in these comments by reference and as Exhibit 1.

accounts for the higher risks faced by the cable industry and by maintaining a differential between the cable rate of return and the telephone rate of return.

III. The Commission Should Not Adopt a Productivity Offset for Cable Operators Under the Price Cap.

The *Further Notice* tentatively proposes to adopt a two percent "productivity offset" to cable rates under the going-forward price cap mechanism. *Further Notice* at ¶ 320. This tentative conclusion is based on the Commission's perception that cable operators will achieve productivity increases that are roughly the same as those achieved in the telephone industry and on the comments filed in the original rate regulation proceeding by the New Jersey Board of Regulatory Commissioners (the "NJBRC"). *Id.* at 319-20. As shown below, there is no basis to impose any productivity offset on cable operators at this time.

First, it is inappropriate to impose a productivity offset at this early phase of cable rate regulation. For many, and perhaps most, cable operators, the full effects of the Commission's benchmark and cost of service rules have yet to be determined. It would be inappropriate to further unsettle the transition by imposing another offset to cable rates; the effects of the current rules have yet to be evaluated. This is particularly important in light of the Commission's decision to adopt the cost of service rules on only an interim basis, because the interim nature of the rules creates additional uncertainty. *Further Notice* at ¶ 5. In addition, because the Commission already has determined that consumers across the country will benefit from billions of dollars in price decreases under the current rules, there is no immediate need for further action to lower prices.

It also is important to remember that the productivity offsets adopted in the Commission's price cap proceedings and in the states' alternative regulation proceedings were, to a certain extent, a *quid pro quo* for relaxed regulation of telephone earnings. As Chairman Patrick put it, telephone companies were given a "mark," and if they could beat it, they could benefit.[15] In fact, LECs are permitted to choose their preferred productivity offset under the Commission's price cap rules, with greater potential rewards available to LECs that choose the more difficult productivity offset. *See* 47 C.F.R. § 61.45(b). There is no such element in cable rate regulation, and the Commission's rate regulation regime cannot be perceived as a reward to cable operators.

There also is little, if any, evidence to support the thesis that cable operators, on average, will be able to achieve increases in productivity beyond the national average. Unlike the telephone industry, which has been studied extensively for decades, there are no forty-year longitudinal studies of cable that show the kinds of consistent productivity gains that characterize the telephone industry.[16]

15/ *See* Policy and rules for Dominant Carriers, *Report and Order and Second Further Notice of Proposed Rulemaking*, 4 FCC Rcd 2873, 3375 (1989) (separate statement of Chairman Dennis R. Patrick).

16/ *See* Policy and Rules Concerning Rates for Dominant Carriers, *Supplemental Notice of Proposed Rulemaking*, 5 FCC Rcd 2176, 2212-17 (1990). Despite extensive record evidence submitted over two years, the Commission was not satisfied with the
(continued...)

Telecommunications studies, some of which may incorporate cable as one of the studied industries, are of little use because they are not cable-specific.

At the same time, while telephone industry costs are fairly well defined and are known to be declining, there is significant evidence that cable costs are likely to increase as time goes on. For one thing, the cable industry is unlikely to have much more low cost growth, because the cable industry has completed construction in almost all of the densely populated areas in the country. The bulk of future expansion will be in higher cost, not lower cost areas, such as areas with fewer than 10 houses per mile.[17/] Costs also are certain to increase in the near term because of the additional obligations imposed on cable operators by the 1992 Cable Act, including must carry, retransmission consent arrangements, customer service obligations, leased access requirements and even the cost of complying with the requirements of rate

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16/ (...continued)
data and ultimately conducted its own, telephone-specific study covering a fifty-year period. Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order*, 5 FCC Rcd 6786, 6798 (1990). There is no such cable-specific data for any period in the record of this proceeding.

17/ Expansion of cable service in the future is likely to be concentrated in fringe areas of existing systems, where costs per mile are higher, or in lightly populated areas that are not served today. Some cable companies are now building plants in areas with as few as five homes per route mile, a population density well below the Commission's long-time standard of 30 homes per mile for rural area waivers of the telco/cable cross-ownership prohibition. Patterns of growth in telephone service, on the other hand, are concentrated in areas of high density and relatively low costs. The telephony growth pattern is confirmed by recent new area code assignments. States like North Dakota, where population density is low, have not required new area codes, but states like California and Maryland, with high population densities, have been adding area codes in recent years.

regulation.[18] Even if there were evidence that cable productivity had exceed the national norm in the past, that evidence would be useless in light of the going-forward costs faced by cable companies.

A productivity offset also would exacerbate the disincentives to investment already inherent in the Commission's rate regulations. Given that, at best, the Commission's rules have significantly increased the risks of investment in cable, additional revenue reductions based on unsupported assumptions about productivity should not be required. If the Commission has any hope that cable operators will be able to provide part of the Administration's information highway, it is particularly important to avoid further reductions in cable revenues.

Finally, the NJBRC filing does not provide any meaningful support for a productivity offset. The NJBRC filing essentially picks a number — two percent —

18/ Telephone companies have claimed that the costs of the cable and telephone industries are likely to be similar in the future because of convergence. As is the case with other telephone industry convergence claims, this demonstrates that the telephone companies do not really understand the cable business. It is true that some functions provided by the two industries are similar, but the fundamental businesses are quite different, if only because cable operators must choose and provide the programming their customers view, a risky and expensive enterprise, while telephone companies merely carry communications chosen by others. The telephone and cable industries also have significantly different regulatory obligations, as Comcast and others have repeatedly demonstrated in the Commission's rate regulation proceedings. *See, e.g.*, Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, *First Order on Reconsideration, Second Report and Order, and Third Notice of Proposed Rulemaking*, 9 FCC Rcd 1164, 1211 (1993). It certainly is true that telephone companies have not had regulatory obligations of anywhere close to the magnitude of the 1992 Cable Act imposed on them in the last two years. If anything, the obligations of telephone companies have decreased. *See Bell Atlantic Tel. Cos. v. F.C.C.*, No. 92-1619, slip. op. (D.C. Cir., June 10, 1994) (voiding physical collocation requirement).

at random, and suggests that it would "reflect the known benefits of technology improvements which have been occurring in the cable industry." Comments of NJBRC, MM Docket 92-266, at 16-17. The NJBRC provided no productivity studies, nor any other documentary evidence to confirm the suitability of its suggested productivity offset or the actual productivity gains that could be expected in the cable industry. Against the background of the significant new costs imposed by the 1992 Cable Act and the involuntary nature of cable rate regulation, the NJBRC's undocumented beliefs do not begin to provide the basis for imposing a productivity offset.

Thus, an offset makes no sense in the economic environment faced by cable operators today. The Commission should reverse its tentative conclusion and should not impose a productivity offset.

IV. Conclusion

Comcast has a long-standing commitment to providing high quality cable service to its customers, but Comcast needs the Commission's assistance if it is to maintain that commitment. These comments and Comcast's petition for reconsideration outline the steps the Commission must take. First, the Commission should increase the permitted rate of return in cable cost of service showings to a level that will compensate investors for the risks of the cable business. Second, the Commission should decline to adopt a productivity offset to going-forward cable rates. Finally, the Commission should properly recognize the investments of cable operators in intangible assets and should permit cable operators to maintain their books in the forms they used prior to rate regulation, as proposed in Comcast's petition for reconsideration.

For all these reasons, Comcast respectfully requests that the Commission adopt rules in accordance with the proposals herein.

Respectfully submitted,

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EXHIBIT 1

Comcast Petition for Reconsideration

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PETITION FOR RECONSIDERATION

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Dated May 16, 1994

TABLE OF CONTENTS